# Financial Systems and Labor Markets in the Gulf Cooperation Council Countries

Middle Eastern Department

International Monetary Fund

© International Monetary Fund
November 1997

Cover Design: IMF Graphics Section

**Cataloging-in-Publication Data**

Financial systems and Labor markets in the Gulf Cooperation Council Countries. — [Washington, D.C.] : Middle Eastern Dept., International Monetary Fund, 1997.

p. cm.

ISBN 1-55775-712-7

1. Finance—Persian Gulf States. 2. Labor Market—Persian Gulf States. 3. Manpower policy—Persian Gulf States. I. International Monetary Fund. Middle Eastern Dept.

HG187.3.F46 1997

Price: $15.00

Address orders to:

International Monetary Fund, Publication Services
700 19th Street N.W., Washington D.C. 20431, U.S.A.
Telephone: (202) 623-7430
Telefax: (202) 623-7201
E-mail: publications@imf.org
Internet: http://www.imf.org

# Preface

The economies of the countries of the *Gulf Cooperation Council (GCC)* share many features. They are endowed with abundant oil and gas reserves, which have been used to generate considerable wealth, build an extensive network of physical infrastructure, and raise per capita income to more than double the world average. Also, these countries share a long tradition of liberal economic policies, open trade and exchange systems, low inflation, and stable currencies. These positive attributes have created an enabling environment for economic growth and financial stability. At the same time, however, the narrow production and revenue base and heavy dependence on hydrocarbon exports and imports of goods and labor have increased the vulnerability of the GCC economies to external developments and the vagaries of the international oil market.

The key challenges facing the GCC countries are how to sustain a relatively high growth rate and create employment opportunities for a growing number of nationals entering the labor market. Several GCC countries have already begun implementing medium-term reform programs to increase their economies' resilience to adverse oil market developments, strengthen medium-term growth prospects, and create a more conducive environment for private sector activity and employment.

In the aftermath of the 1990–91 regional conflict, remarkable efforts were made to overcome the legacy of the crisis and resume the reform programs that had been interrupted by the war. A premium was put on fiscal consolidation through mobilization of non-oil revenue and expenditure restraint, with most of the GCC countries setting for themselves the target of achieving fiscal balance by the year 2000. Supported by higher oil prices in 1995 and 1996, fiscal consolidation efforts in all GCC countries have reduced significantly financial imbalances, helped eliminate the external debt of Saudi Arabia and Kuwait, and restored private sector confidence. Moreover, a qualitative shift in economic policies toward liberalization, deregulation, and promotion of private sector activity has been taking place throughout the region.

An important feature of the medium-term plans has been the increased emphasis on structural reforms, including government disengagement from commercial activities, privatization, and financial sector reform, as well as a heightened interest in labor market issues and policies. Healthy and dynamic financial intermediaries and deeper capital markets are essential to supporting private sector growth and enhancing the beneficial effects of reforms in other areas. In turn, efficient labor markets would contribute to economic growth and diversification while supporting job creation.

This volume comprises two separate papers on key structural aspects of the reform process in the GCC countries. The first paper addresses issues related to financial intermediation and reform in the context of the evolving economic environment in the GCC countries. The second discusses the labor market challenges and policy issues in the GCC countries and their implications for the Middle East and North Africa (MENA) region.

The authors are grateful for valuable comments and input from colleagues in the Middle Eastern Department. Special thanks are due to V. Sundararajan for comments on the financial systems paper, and to Mohamed A. El-Erian and Susan Fennell for comments on the labor market paper. The authors greatly appreciate the valuable research assistance provided by Sayeed Mahyoub. Martha Bonilla, of the External Relations Department, edited the publication. Maria Llames, Joan Wise, and Anne Yee were helpful in the final preparation of the manuscript. The views expressed in this study are the sole responsibility of the authors and do not necessarily reflect the views of the Executive Directors of the IMF or other members of the IMF staff.

# Financial Systems and Reform in the Gulf Cooperation Council Countries

*Abdelali Jbili, Vicente Galbis, and Amer Bisat*

## Executive Summary


- Since the end of the regional crisis in 1990–91, the Gulf Cooperation Council (GCC)[1] financial systems have witnessed a rapid development and integration with international financial markets, under the effects of profound changes in the economies of the region that stemmed from the impact of the Gulf war and the economic reforms that have been initiated thereafter.

- In the aftermath of the war, bank intermediaries increased their deposit and capital base, improved productivity by acquiring new technology, and enhanced their profits by developing consumer-based services. In addition, the monetary authorities in all GCC countries moved to strengthen prudential regulations and bank supervision.

- However, competition has remained relatively limited, with restrictions applying to bank licensing and foreign participation; domestic capital markets lack depth and diversification; and, in a number of cases, equity investment and financing continue to face supply constraints and restrictions concerning listing and trading.

- Looking forward, the GCC financial systems will also need to respond to a number of challenges emanating from fiscal retrenchment and the strengthening of the role of the private sector, including the need to mobilize private financing for large investment projects in telecommunications, power, transportation, and the petrochemical industry. In addition, financial intermediaries will need to meet an increased demand of more sophisticated financial services by a young and wealthy population.

- The GCC countries have already completed most of the crucial stages of liberalization and financial reform, and unlike many other countries of the Middle East and North Africa (MENA),[2] their financial systems are not encumbered with distortions. Key reforms, however, should aim at strengthening market forces, opening up the financial sector to foreign competition, strengthening bank soundness by enhancing the regulatory and supervisory framework, and developing the capital markets.


---

[1]The GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

[2]MENA countries include the members of the Arab League, the Islamic Republic of Iran, and Israel.

# I. Introduction

During the 1970s and the early 1980s, the GCC countries made significant progress in financial deepening and in building a modern financial infrastructure. Abundant oil revenue led to the accumulation of sizable official foreign assets and private wealth, part of which were intermediated by GCC financial institutions. Moreover, the GCC countries, which were net providers of savings to the rest of the world until the early 1990s, had little constraint in mobilizing resources for the financing of domestic investment projects, most of which were undertaken by governments. However, activity of the GCC financial intermediaries continued to be centered around their traditional niche consisting mainly of short-term lending to trade, building and construction, and small manufacturing. It was not until the early 1990s that the process of rapid development of financial intermediation and integration with international financial markets started to take hold under the effects of profound changes in the economies of the region, stemming, in particular, from the impact of the Gulf war and the economic reforms that have been initiated thereafter.

With the end of the Gulf war and the return of confidence, banks strengthened their deposit base, and improved productivity by acquiring new technology and developing lucrative consumer-based services (e.g., credit cards, automatic teller machines, consumer lending). Increased capitalization, higher profits, and government assistance, in Kuwait, for example, allowed the banks to compensate for the bad loan problems that had plagued a number of them. Other segments of the financial sector, however, have not made similar progress. Domestic money markets have remained underdeveloped, lacking depth and diversification. Stock exchanges have faced various constraints, despite the existence of a potentially large demand for equity investment; and corporate bonds and secondary markets for government paper have not emerged in a significant manner.

Looking ahead, the GCC financial systems face a number of challenges stemming from the need to adapt to the rapid globalization and support the policy changes that are currently shaping the region's economies, namely (1) the increased role of the private sector; (2) the strong demand for new financial services and, more generally, the need to better manage domestic savings; and (3) the gradual opening up of activity to foreign participation. Increased competition at the domestic and international levels in the period ahead will put a premium on efficiency and productivity and require enhanced prudential regulation and bank supervision to reduce risks and preserve the soundness of the banking system. Equity markets would need to be developed further to help promote private sector saving and investment.

This paper reviews the structure and key policy issues in the financial systems of the GCC countries. After a brief overview of the main characteristics of the bank intermediaries and the financial system in general in Section II, the key challenges facing these systems are highlighted in Section III in relation with the ongoing changes in the region, including the economic reforms underway. This provides a basis for the subsequent

presentation of the reforms needed in many GCC countries (Section IV) to strengthen capital markets; increase competition; open the markets to new entry, including by foreign institutions; and meet the challenges of fostering dynamic financial institutions and equity and bond markets.

# II. Structure of the GCC Financial Sectors

## A. Banking Intermediation

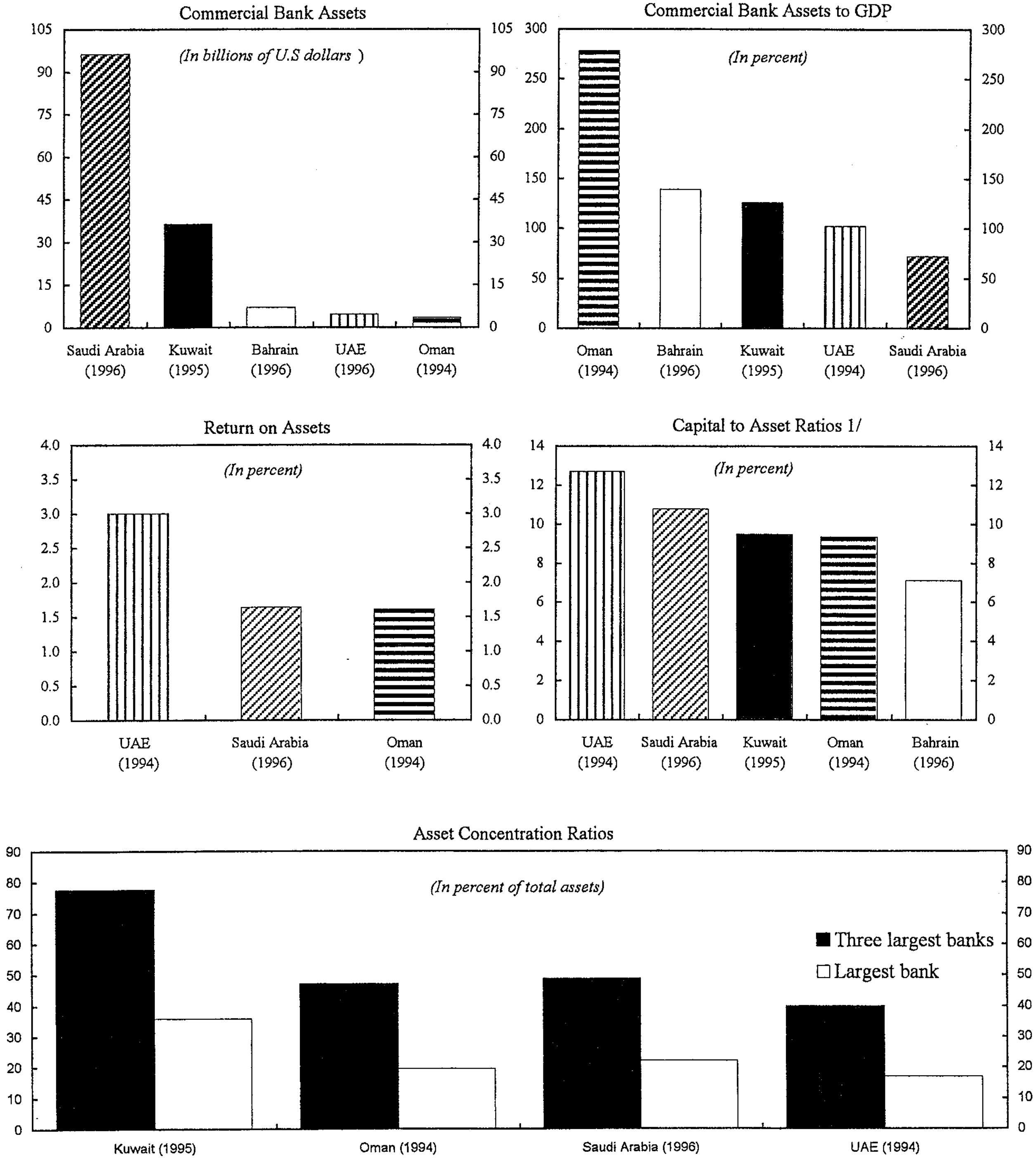
The GCC countries have a fairly large number of banks with extensive networks of branches. Banks are also, with few exceptions, financially strong and well capitalized, with total assets ranging between 70 percent of GDP for Saudi Arabia and 280 percent for Oman, levels that are high by international standards (Chart 1). In 1995, the region boasted 9 banks with assets exceeding US$5 billion each, of which three had assets of more than US$10 billion each. Moreover, in most GCC countries, the value added of financial services currently accounts for about 10 percent of non-oil GDP.

Most of the region's banks were originally branches of major international banks until the mid–1970s when foreign banks were required to transfer ownership to domestic residents; at present, foreign banks are permitted only minority ownership of local banks. All GCC countries have moratoria on the licensing of new banks. They have recently agreed to permit local banks to establish branches in other GCC member countries. Although private ownership of banks is predominant in many GCC countries, government equity participation in financial institutions is widespread and a large number of banks and specialized financial institutions are fully controlled by the public sector. Moreover, in many cases, private sector ownership tends to be concentrated in a few shareholders.

Licensing and foreign ownership restrictions may have resulted in a relatively high degree of banking concentration. In Saudi Arabia (1996) and Oman (1994), the three largest banks accounted for approximately one-half of total bank assets, equity, and loans, with one bank accounting for approximately one-fifth of assets and equity. These ratios are even higher in Kuwait, where the three largest banks accounted for nearly 80 percent of the banking sector's total assets and equity in 1995, while the largest single bank accounted for one-third.

By traditional measures of financial deepening, the region is well monetized. In most countries, the ratio of money supply to GDP is high, ranging between 50 percent and 90 percent, and has been relatively stable over the years reflecting the banking sector's ability to attract increased deposits (Chart 2). The extent of monetization and the banks' success in mobilizing longer-term financial assets are also evidenced by low ratios of currency and short-term deposits to broad money (27 percent on average in 1996), and of ratios of currency-to-deposit (average of 10 percent in 1996). The high degree of monetization is a testament to the increased confidence in banks and the ability of the latter

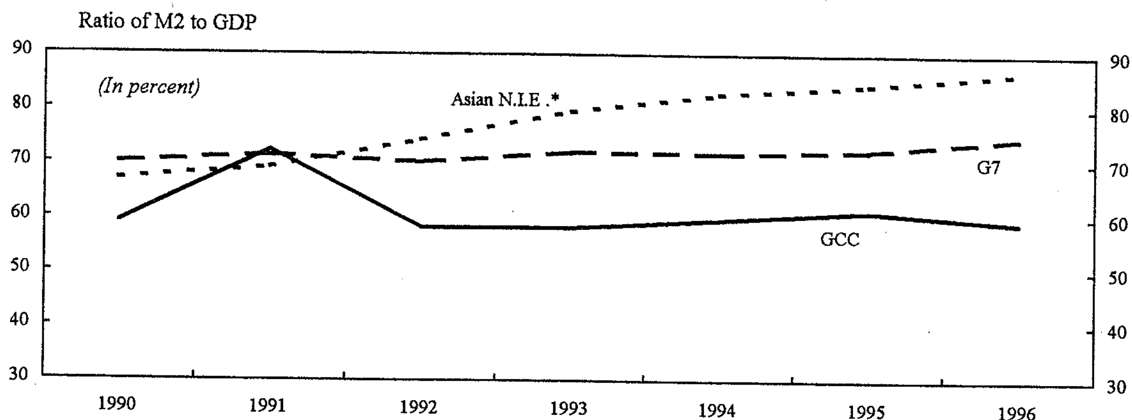
# Chart 1. GCC Countries: Banking Sector Indicators

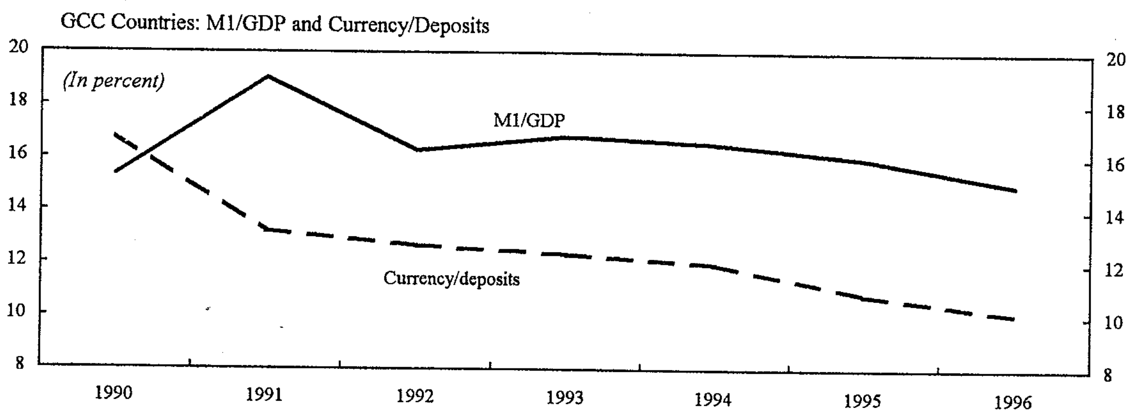


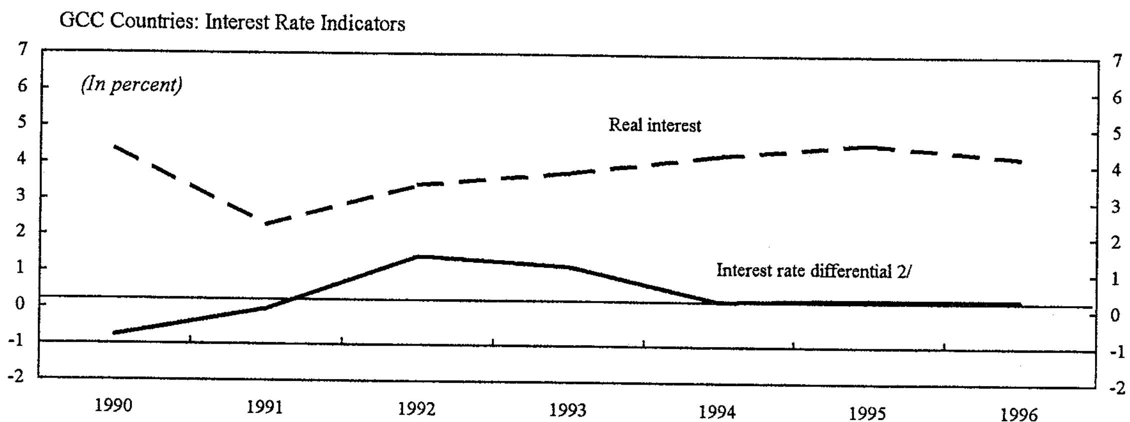

Sources: Data provided by the authorities; Middle East Economic Digest (MEED); MEED MONEY.

1/ Assets are not risk-weighted.

## Chart 2. GCC Countries: Financial Indicators, 1990–96 1/




Sources: Data provided by the authorities; International Monetary Fund, *International Financial Statistics*; and *World Economic Outlook*.

1/ All indicators are regional averages.

2/ Interest rate differential between domestic interest rate and similar maturity U.S. dollar LIBOR rate.

* Newly industrialized economies of South East Asia.

to utilize advanced consumer banking technologies. Usage of automated teller machines and point-of-sales technologies is widespread; tele-banking services and the usage of credit and debit cards are expanding. Such technologies have been supported by advanced computerized payment and settlement mechanisms.

Reflecting the relatively limited—albeit expanding—share of the private sector in economic activity in the GCC countries, bank lending to the nongovernment sector has remained modest in most countries.[3] Notwithstanding problems of private/public sector distinctions in the statistical accounts (especially in monetary data), credit to the nongovernment sector averages less than 40 percent of GDP for the GCC countries and less than two-thirds of total credit, shares that are lower than those in the G-7 industrial countries and the fast growing economies of East Asia (Chart 3). By contrast, the region's banks have been generally active lenders to the government sector, with Kuwait and Qatar having the highest shares.

The relative importance of lending to the government sector reflects the increased recourse to bank borrowing to finance the large fiscal deficits that emerged as a result of the Gulf crisis and the subsequent decline in oil prices, as well as other factors such as the floating of government bonds to finance payments to farmers in Saudi Arabia, the taking over of bad debts by the Kuwaiti government under the Debt Collection Program (DCP), and the financing of large gas and petrochemical projects in Qatar, to mention only a few examples. While the share of credit to the private sector has been increasing since 1990 in all GCC countries, part of the private sector's financing needs (especially for investment) has been met either through liquidation of private assets held abroad, or through borrowing from foreign banks and off-shore banking units.

Bank lending continues to be of a predominantly short-term nature and is heavily concentrated in traditional sectors, such as trade, and construction and real estate activities, which together, account for about 30–45 percent of the total, while the industrial sector's share has generally been less than 10 percent. However, the GCC banking sector has recently experienced a marked increase in personal credits, the share of which in total credit has reached 30–40 percent in some countries. This reflects high demand for consumer loans by an increasingly young and wealthy population, as well as a rising demand for bank loans to finance equity purchases.

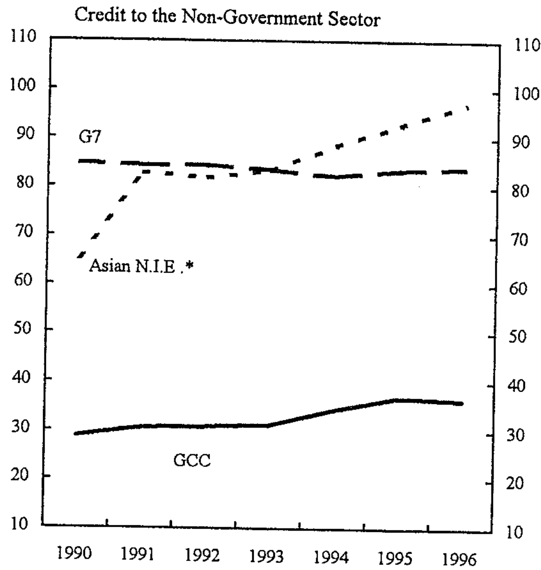
## B. Framework and Instruments of Monetary Policy

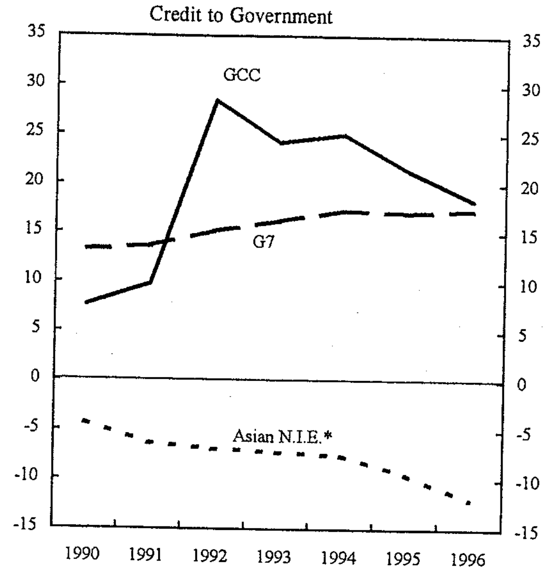
The GCC countries have open economic systems with free movements of capital and fixed exchange rate arrangements. This institutional setting has implications for the conduct and the effectiveness of monetary policy, which is geared toward maintaining

[3]Since credit to public enterprises is usually aggregated with credit to the private sector, it is more accurate to refer to credit to the nongovernment sector.

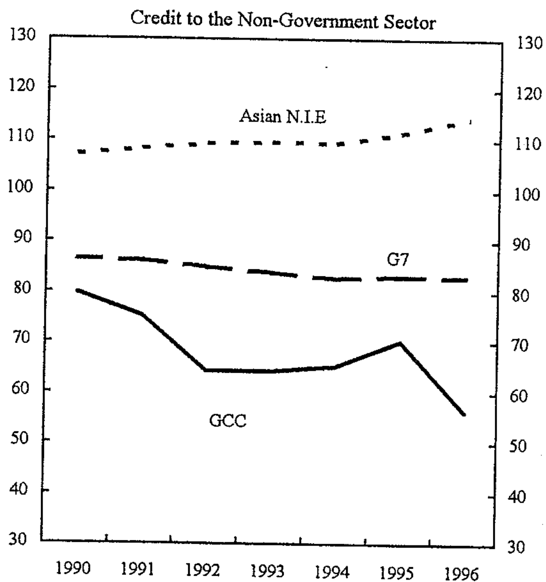
## Chart 3. GCC Countries: Credit Indicators, 1990–96 1/

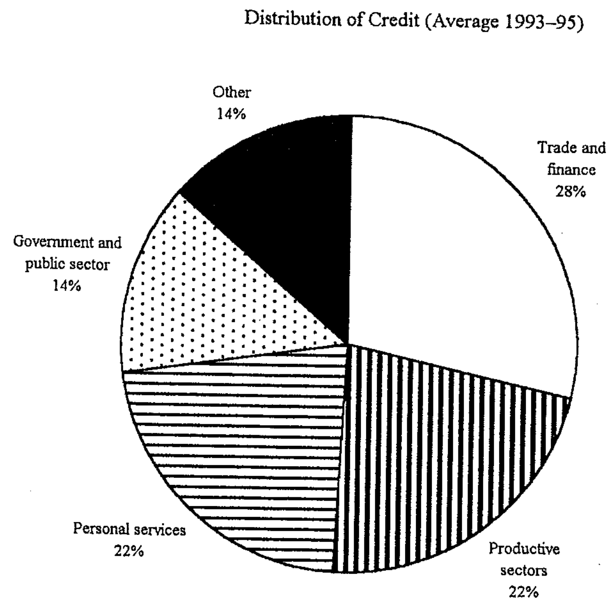
*(Ratios to GDP)*




*(In percent of total credit)*




Sources: Data provided by the authorities; International Monetary Fund, *International Financial Statistics;* and *World Economic Outlook.*

1/ All indicators are regional averages.
* Newly industrialized economies of South East Asia.

stability of the exchange rate arrangements.[4] In this framework, demand pressures, created mainly through fiscal deficits, have tended to be absorbed through the balance of payments, thus mitigating the monetary impact of deficits. Thus, during 1985–90, money supply grew by only an average 2.9 percent a year, despite relatively high fiscal deficits. Since then, government deficits have been reduced in all the GCC countries through fiscal consolidation efforts, which have eased the pressures on the balance of payments while permitting money supply to continue to grow at moderate rates (averaging 4 percent a year over the past five years). Under these conditions, the scope of monetary policy is limited to primarily regulating short-term liquidity and smoothing out volatility arising from exogenous shocks, while the burden of adjustment falls on fiscal policy.

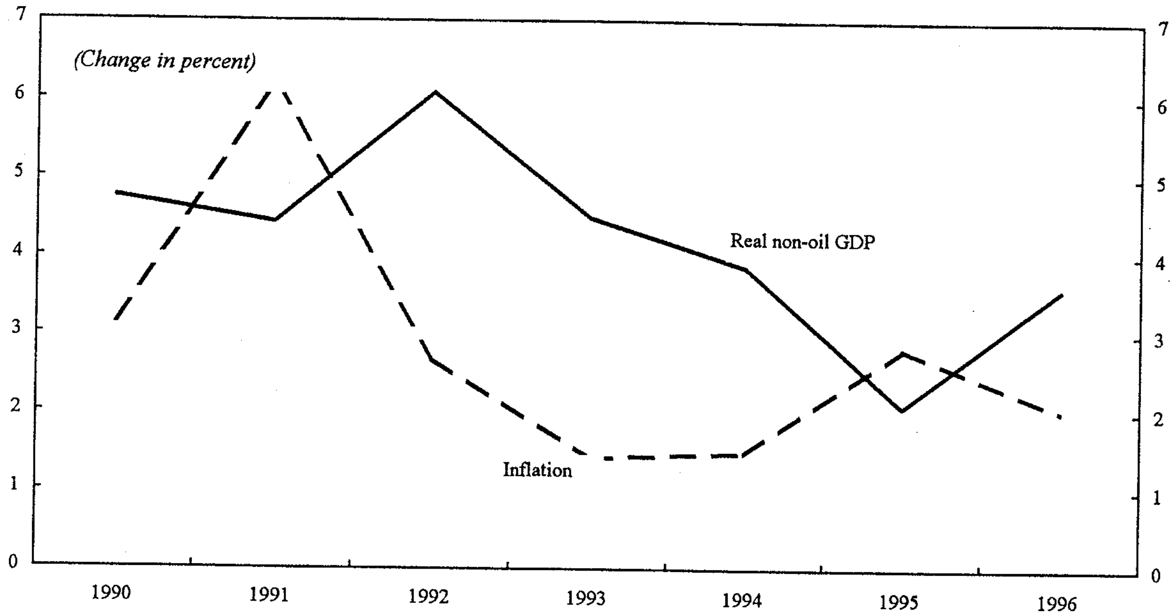
The use of instruments of monetary policy by GCC central banks has varied in recent years with increasing reliance being placed on market-based instruments. In Bahrain and Kuwait, the authorities use open-market operations (purchases and sales of government securities, repos of government securities); open-market-type operations (outright sales in the primary market); and central bank-lending operations (overdraft window, overnight lending). The Central Bank of Kuwait also has a "liquidity scheme" in the form of one-month deposits with the central bank at a competitive interest rate, which is used when the ceiling on treasury bills and bond issues is reached. The U.A.E. Central Bank relies mainly on purchases of foreign exchange, although it uses a swap facility and transactions in central bank certificates of deposit. The Qatari authorities also operate a discount window facility. The main instruments used by the Saudi Arabian Monetary Agency (SAMA) to smooth out liquidity and interest rate movements are repo operations in government bonds. Other instruments used by SAMA include foreign exchange swaps and the placement of government deposits in different banks. However, in all countries, the lack of deep and well-structured secondary markets for government paper has hampered the further development and effectiveness of open-market operations. Finally, recourse to certain direct instruments of liquidity management has been maintained mainly for prudential purposes, in the form of mandatory loan-to-deposit ratios, and ceilings on consumer credit and interest rates.

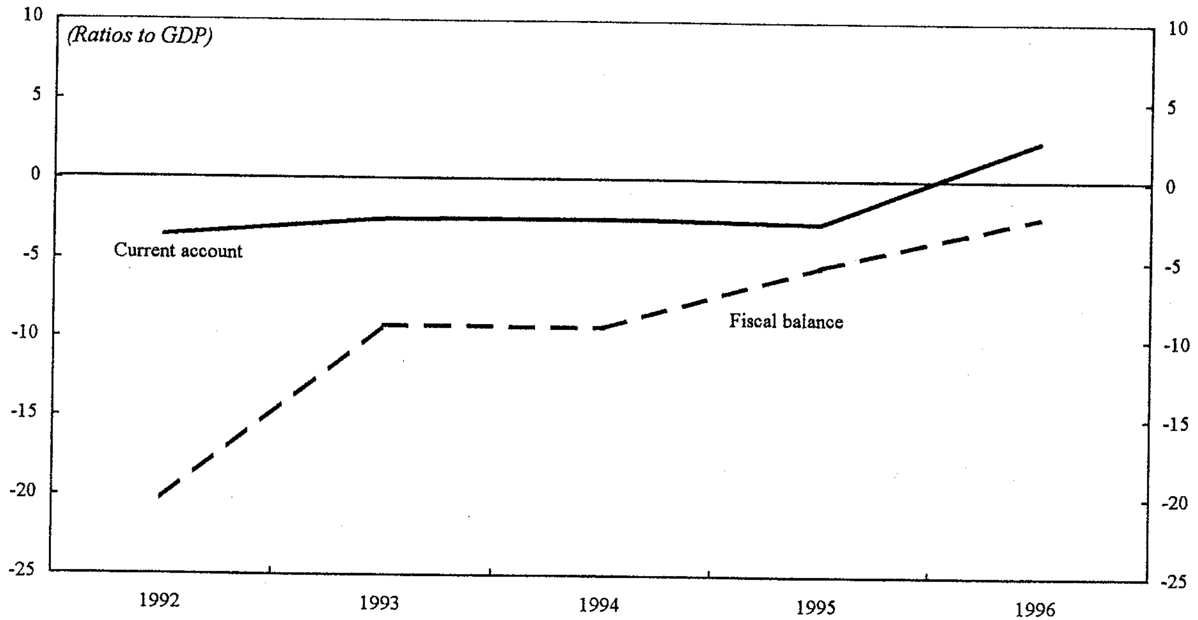
Owing to the existing fixed exchange rate arrangements and the freedom of capital movements, interest rates in the GCC region have usually closely tracked interest rates on U.S. dollar-denominated assets—except for temporary deviations in response to exogenous shocks, and upward deviations explained by transaction costs and risk factors. The recent strengthening of the region's macroeconomic balances has led to a further decline in interest rate differentials in most countries (Charts 2 and 4). While most GCC countries had maintained restrictive regulations on interest rates in the early 1970s, since then, there has been a progressive easing, with interest rates now largely determined by market forces in most countries. Nevertheless, some restrictions remain in a few countries, such as

---

[4]Most GCC countries' currencies are de facto or de jure pegged to the U.S. dollar, except the Kuwaiti dinar, which is pegged to a basket of currencies.

## Chart 4. GCC Countries: Macroeconomic Indicators, 1990–96 1/




Sources: Data provided by the national authorities.

1/ All indicators are averages for the region.

ceilings on deposit rates and caps on lending rates or on consumer loans. Some of these ceilings are either nonbinding or affect a small share of overall financial transactions. Because of the region's low rates of inflation, interest rates have generally been positive in real terms, with real rates ranging in most countries between 3 percent and 5 percent. Most GCC banks have a deposit interest rate yield structure with rates that fluctuate across maturities and provide a premium for longer-term deposits; however, the term structure of lending rates has remained generally less wide.

## C. Banking Soundness, Regulation, and Supervision

Since the early 1980s, the GCC financial sectors faced a number of difficulties, including the 1982 crash of the informal stock exchange (*Souk Al-Manakh*) in Kuwait, and the property market collapse of the 1980s. With the drop in international oil prices and the cut in government expenditures in the mid–1980s, a number of banks faced difficulties as sizable loans turned nonperforming. However, since then, banks have increased their "general" provisions and capitalization in response to the introduction of stricter prudential regulations, and also partly reflecting improved management practices and higher profits. Banking problems have also been resolved through mergers and closures and, in some cases (notably Kuwait), government assumption of bad debts.

A key factor behind the improvement in the region's bank soundness indicators has been the strengthening of prudential regulations and central bank supervision. All GCC countries have established provisioning and capital adequacy requirements that are generally stricter than those prescribed under the Basle rules. Moreover, all central banks carry out on-site inspections and off-site analysis of banks. While prudential regulations vary across countries (e.g., foreign currency exposure limits; credit concentration ratios; limits on consumer lending; and liquid asset ratios), few countries have guidelines for bank management standards, and only a few systematically regulate and supervise nonbank financial activities (e.g., derivatives; Islamic banking; mutual funds; and brokerage houses). International accounting and risk evaluation standards and early warning systems for the identification of bank difficulties exist in only a few countries. Some countries have introduced a deposit insurance scheme, while others are preparing the necessary regulations.

Partly as a result of the strengthened regulatory and supervisory standards, the GCC banks tend to be well capitalized (in absolute terms and when measured against the Basle requirements). For instance, the region's (simple) equity-to-asset ratio ranges between 7 percent in Bahrain and 13 percent in the United Arab Emirates. When assets are risk weighted, the capital adequacy ratios reach levels that are among the highest in the world (22 percent in Saudi Arabia and 21 percent in the United Arab Emirates); these ratios partly reflect the large share of lending to government, which has a low risk weight. However, the situation of individual institutions with regard to capitalization varies substantially.

## D. Nonbank Financial Intermediation

Despite the moratoria on new (and foreign) banks, the financial structure of the GCC countries has diversified over time with most of the expansion accounted for by branching activities, money changers, and investment offices. Most GCC countries are home to investment banks, insurance companies, foreign exchange- and money-brokers, representative offices of foreign banks, and general "financial service units." Investment banks engage primarily in securities underwriting, investment advice, and portfolio management. Money brokers are typically affiliates of established international firms and facilitate transactions in financial instruments (primarily, negotiable certificates of deposit and foreign exchange). Representative offices are essentially agencies set up by foreign financial institutions to gather economic, financial, and commercial information for their principals and to provide general assistance to local and regional customers of these principals. Some countries (e.g., Bahrain) have recently licensed mutual funds that are separate from banks.

Government securities issued by GCC countries are mostly held by banks, pension funds, and specialized institutions. There are no active secondary markets in these securities and there are usually limits on bank purchases of treasury bills. With the aim of strengthening secondary markets, some GCC commercial banks have been allowed to issue negotiable certificates of deposit (CDS) (Oman in 1994, and the United Arab Emirates—dollar-denominated CDS—during 1993/94).

All GCC countries possess large public sector specialized banks focused on sectoral lending at below market interest rates (e.g., agriculture; industry, and small- and medium-sized companies). Their operations are financed by budgetary transfers rather than deposit-taking activities.

One area that has recently experienced rapid growth relates to Islamic financial operations. Islamic banks and Islamic investment institutions have now over US$70 billion of assets worldwide. The origin of such activities in the GCC countries dates back to the early 1970s when institutions were set up with the objective of recycling the oil-related surplus in accordance with the Islamic *Sharia*. Early operations focused on trade-related financing and leasing operations and tended to mobilize funds of individuals who shunned interest-bearing bank accounts. By the early 1990s, many GCC commercial banks (as well as nonregional institutions) had started Islamic banking operations. A number of new Islamic investment funds have been launched during the past two years to manage wide-ranging portfolios of shares in companies whose activities are compatible with Islamic principles. Returns on Islamic operations have, so far, been high. A major policy issue in this regard is how to strengthen regulation and supervision of such activities (Box 1).

Equity markets in the region are expanding as the scope for private enterprise is increasing and demand for equity investment is rising (Chart 5 and Box 2). Saudi Arabia's equities market is by far the largest in the Arab world in terms of capitalization, but transactions are exclusively handled by the banks and trading is relatively modest. The Kuwait Stock Exchange is the most active in the GCC area and one of the largest in the